

EYES WIDE SHUT: GOOD GOVERNANCE OF STATE-OWNED ENTERPRISES

Modernizing Corporate Law Legislation

In the previous edition of Nos Florin, our colleagues at VanEps, Kunneman VanDoorne conclude that it is more important that the state [of Aruba] reflect on modernizing corporate law legislation, before implementing foreign corporate governance codes (Nos Florin 6, Pag.57). They contend that the [small-island] status quo is not conducive to guidelines of good governance. But what, if anything, does research indicate? Do we merely modernize corporate law legislation, or should we consider modernizing our state-of-the-art?

Empirics of Good Governance

The agency model is the dominant theory of the corporation and corporate governance arrangements. It assumes that the owners of an enterprise (the principal) and those that manage it (the agent) will have different interests. Hence the shareholders of any enterprise face a problem that managers are likely to act in their own interests rather than the shareholders. The agency model also assumes that information is a commodity and can be freely exchanged. The agency model sees corporate governance arrangements as a means to ensure that management acts in the best interests of shareholders. From this perspective the main function of the board is to control managers. This suggests that a majority of directors of companies should be independent of management (executive or managing board), and that the primary role of the supervisory board is one of ensuring managerial compliance, i.e., to monitor and control the behavior of management to ensure it acts in the best interest of shareholders; this assumes of course that the board is acting in the best interest of the

shareholders. Studies indicate that this is not always necessarily the case, and conflicts often arise between shareholders and supervisory boards. Using the agency model, different mechanisms have been developed and refined, including:

Composition of the supervisory board: Separation of the CEO/Director and the Chair/President of the supervisory board position, which may or may not coincide with a (Anglo-Saxon) two-tier structure. From an agency perspective, it is assumed that 'outsiders' are more independent; a view that has no empirical support. Board size (number of members) has no significant impact on corporate performance and shareholder wealth creation. Increasing board size is negatively correlated with governance effectiveness due to increasing costs of coordination, and the loss of flexibility and responsiveness – two fundamental criteria for successfully privatizing an enterprise. Research suggests that, in general and all other factors being equal, corporate boards consisting of 4 to 7 members outperform boards consisting of less than 4 or more than 7 members.

Financial control systems: Explicit and formal information and control systems based on financial/risk reporting, monitoring and general accounting principles. The basic premise underlying financial control is that more control (e.g., more information on financial performance) leads to less personal guile, and thus to better corporate performance (i.e., shareholder wealth creation); a view that has little empirical support. Financial and accounting measures provide an 'ex-post' view of corporate performance, and fail to address 'ex-ante' or future

expectations of performance. While hindsight is required, without foresight there can be no clear steering.

Executive board ownership: ownership of company stocks by board members is hypothesized to increase company loyalty and shareholder value. Corporations that utilize executive board or CEO compensation plans that are positively related to corporate performance, will experience better performance than corporations where CEO compensation is not tied to corporate performance achievements (assuming that the executive and supervisory boards agree on performance goals and key performance indicators). Research indicates that management compensation plans only work when there is a 'base remuneration' tied into the variable performance-based compensation. One of the fundamental pre-requisites for effective governance systems is a strategic agreement on the performance goals, measures and key performance indicators. Without this shared understanding no amount of control will suffice. Furthermore, management compensation plans are particularly effective in combination with 'outsiders' on the board (i.e., more than 60% of the members are so called 'independent'). Management compensation and board composition thus show interaction effects.

Management tenure: as the tenure of the CEO increases, the company's performance will also increase. Tenure is often based on performance achievements within a specified period of time. Research suggests that effective tenure periods can range anywhere between 5 and 9 years. The first two years, performance tends to decline or stabi-

lize (very often associated with 'turn-around strategies', 'political turbulence' and/or 'economic uncertainty'; after 10 years corporate performance tends to decline due to the 'stale in the saddle' syndrome. In sum, there is a curvilinear relationship between tenure and performance. However, tenure has a negative impact on corporate performance, if and when, this is combined with 'insiders' on the board (i.e., more than 60% of the members are directly related to the company). Tenure and board composition thus show interaction effects.

Reality Check

When one compares the foregoing mechanisms to the Aruban context, one has to wonder if we are governing with our 'eyes wide shut'. First of all, we need to acknowledge that state-owned enterprises in small-island contexts operate in a relatively regulated marketplace, in which the government is often the main (and sometimes only!) shareholder. In theory, market mechanisms can regulate governance systems. However, due to the 'monopolistic-like' nature of the industries in small-island contexts, market mechanisms are unlikely to provide any incentives to regulate the governance system. This would require a fundamental liberalization policy on the part of the market and government.

Furthermore, experiences and empirical research in Italy, France, Japan, and Malaysia indicate that 'business' governance systems do not apply to 'state-owned' governance systems, i.e., principles and mechanisms are not universally applicable, and have a negative impact on corporate performance and shareholder satisfaction; particularly in the first stages of corporate governance implementation and development. Research suggests that mature 'state-owned' governance systems tend to evolve over time – 3 to 5 years, and with the maturation of governance stability and political climate

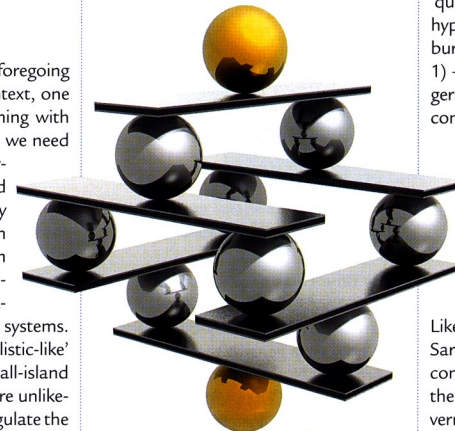
- towards more 'business-centric' governance systems.

Within small-island economies, personal clout and social capital (i.e., the development of personal relationships based on trust and legacy) are fundamental to the functioning and health of any type of organization (public or private). Assuming that 'control' and 'independence' will guarantee any type of sustainable corporate performance is elusive. The cases of Italy, France, and Japan serve as

and the risk of inconsistency and unstable corporate performance become the biggest risk factors in terms of integrity, transparency, and accountability. Add to the foregoing the (small) size of companies and the (relatively limited) access and availability to financial, human, and intellectual capital, and it becomes painfully obvious, that, unless we want to create corporate governance 'overhead', and thus minimize corporate efficiency and governance productivity, and do away with any type of economies of scale and scope (due to 'heavy outsiders' and 'quick tenures'), institutionalizing large hyper-specialized corporate governance bureaucracies have no value (see Exhibit 1) – not for shareholders, not for managers, nor for employees, customers or the community.

Conclusion

Regardless of the Aruban or any other small-island context, the principles and mechanisms outlined in OECD's report 'Guide on Corporate Governance of State-owned Enterprises' are open to scrutiny. Likewise, nor the Cadbury report nor the Sarbanes-Oxley Act enjoy any strong or conclusive empirical support regarding the relationship between corporate governance and corporate performance. The answer is often discovered between the lines and lies. ■



mere examples, where the actual functioning of the corporate governance system is embedded and 'culturalized'. It is not rational independence, but social interdependence that testifies against any type of universal continental corporate governance system. The idea that there are universal best practices is a fallacy; and decontextualizing any governance is an invitation to failure.

Combining state- or government-ownership with political democracy creates an extra dynamic of so-called 'requisite independence' not from 'management-to-corporation' but from 'board-to-government', i.e., the main shareholder. Potential conflicts of interest, political guile,

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